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The Director of Central Intelligence
Washington, D.C. 20505

National Intelligence Council

NIC #05960-84
18 October 1984

MEMORANDUM FOR: Director of Central Intelligence
Deputy Director of Central Intelligence

FROM: Maurice C. Ernst
NIO/Economics

SUBJECT: Potential Threats

Since this will be the last time I participate in this process, I have ranged more widely than usual to give you my impressions on what I believe to be some critical issues.

El Salvador

Although most recent indicators are favorable, it is much too early to claim victory. Recent DDI studies appear to show a decline in insurgent activity against difficult targets, a leveling off of overall insurgent personnel strength and area control, and some loss of morale and sense of direction among the insurgents themselves. But the evidence also indicates a continued increase in the insurgents' military capabilities--the number of men trained and equipped. Moreover, it is highly probable that the insurgents' foreign supporters (the Soviets, Cubans, and Nicaraguans) could supply more and better arms if they wanted to, which would further increase the insurgents' military capabilities. Why then are military activities and apparently morale relatively weak while military capabilities are increasing, and could be increased further? It seems to me that there are three main explanations:

- o As the DDI studies show, the insurgent movement has not caught on politically in El Salvador. Apparently the insurgents have not been able to take advantage of the population's problems with the government. Although this does not mean the government is popular, the evident lack of broad insurgent support is a major plus since they have to gain this support to win the war.

- o The various insurgent factions have not been able to get their act together. They apparently manage to cooperate to some

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extent on a tactical level and in the distribution of imported arms, but are not able to agree on overall strategy. This is an obvious vulnerability, of which the government is trying to take advantage through its peace feelers.

- Both the insurgents and their foreign supporters are scared to death of what the US might do if they took stronger actions. Even though the insurgents and the Nicaraguan government are aware of the political divisions over this issue in the United States, they also know that the US is easily capable of decisive action, and with their own survival at risk, are likely to be cautious. Consequently, US policy probably has strongly inhibited both insurgent activities and the amount of foreign support they have received.

The Persian Gulf

With the deliveries of additional Mirage aircraft, the Iraqis by early next year will have the capability to mount enough attacks on tankers serving Kharg Island to substantially reduce Iran's oil exports. Should they launch such attacks, the Iranians probably either would reply in kind, or launch their long-awaited offensive. On the other hand, the Iraqis may have reasons not to rock the boat:

- Their political, economic, and military situation is tolerable and stands a reasonable chance of improving in the future. Iraq is obtaining plenty of weapons; its military is better led and organized; its economy is no longer deteriorating; internal political threats do not appear strong. Moreover, within a year or so, an oil pipeline linked to Saudi Arabia should be completed, which will permit a significant increase in export earnings, and on an improvement in the domestic economy.

- Iranian political divisions may keep the military front relatively quiet.

- The Saudis and other Southern Gulf states may use their large economic aid to Iraq as leverage to dissuade the Iraquis from taking destabilizing steps.

Even so, with the Iraqi air strike capability substantially increased, we should watch events in the Persian Gulf closely.

The Dollar

Most economists believe that the current economic expansion in the US and other OECD countries will last at least through mid-1986. After that, most expect a slowdown, and some expect a US recession. And almost all agree that the principal contingency that could upset the apple cart before mid-1986 would be a precipitous drop in the value of the dollar.

No one is actually predicting a big drop in the value of the dollar; indeed, many bet on a lower dollar in the past year or so and got so badly burned that they are very reluctant to take that chance again. Even so, the dollar is so high and the US current account deficit so large that the downside risks must be substantial.

A big drop in the dollar could occur because foreigners become unwilling to continue rapidly increasing their holdings of dollar assets, which they will have to do as the US current account deficit expands. Moreover, confidence is a fragile thing and could be upset by unexpected events, such as: an unexpected outcome of the US Presidential election; an unexpected acceleration of US inflation; a shift in Federal Reserve policy or leadership; or perhaps a total break in debt negotiations with Argentina or another large LDC debtor. Many believe that the onset of a US recession itself would at least initially weaken the dollar.

If the dollar should fall sharply for whatever reason, it could trigger the following problems:

- A substantial acceleration of US inflation because of higher import costs. Imports now constitute a much larger share of total US supplies than in the past and their influence on inflation is large.

- A rise in US market interest rates as the supply of foreign capital available to finance US private investments and fiscal deficits shrank.

- The likely tightening of US monetary policy in order to combat inflation, which would in turn further raise interest rates and restrict credit to the private sector.

These developments in turn could trigger an earlier economic recession than most people now expect. The US recession would adversely affect economies of other countries, even though the immediate impact of the depreciation of the dollar would be to ease the debt service burden of many LDCs.

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